Postal Regulatory Commission
Submitted 3/20/2017 12:40:58 PM
Filing ID: 99508
Accepted 3/20/2017

The American Consumer Institute
Center for Citizen Research

Comments of the American Consumer Institute Center for Citizen Research Regarding Docket No. RM2017-3 and Order No. 3673 Submitted to the Postal Regulatory Commission, March 20, 2017

About ACI

The American Consumer Institute Center for Citizen Research ("ACI") is a nonprofit (501c3) educational and research institute with the mission to identify, analyze and protect the interests of consumers in select policy and rulemaking proceedings related to information technology, health care, retail, insurance, energy, postal and other consumer issues.

Prior to becoming president of the ACI, I worked for a consultancy that specialized in postal issues and productivity measurements, among other things. During this time, I conducted and filed a total factor productitivity (TFP) study with the Federal Communications Commission on behalf of the United States Telecom Association in connection with its price cap proceeding. Before this, I was chief economist at the Bell Atlantic Corporation, where I conducted over one hundred total factor productivity (TFP) and benchmarking (process improvement) studies.

The comments here are based, in part, on my experience with regulatory reforms in various industries and their potential application to the objectives of establishing a modern system of postal reform.

Failure to Meet Productivity Incentives, Rate Stability and Revenue Adequacy Objectives

In this proceeding, Docket No. RM2017-3 and pursuant to Commission Order No. 3673, the Postal Regulatory Commission ("Commission") seeks comments on the statutory review of the system for regulating rates and classes for market dominant products ten years after the enactment of the Postal Accountability and Enhancement Act ("The Act"). The Act directs the Commission to review the extent to which the USPS is achieving the objectives established by Congress. By any assessment, the USPS has failed to achieve many of its objectives. Among these failures, the USPS has fallen far short on the following key areas:

- Objective 1 – To maximize incentives to reduce costs and increase efficiency; and
- Objective 5 – To assure adequate revenues, including retained earnings, to maintain financial stability.

Price caps were designed as automatic revenue adjustment clauses for the purpose of bypassing costly and time-consuming regulatory rate setting processes. Generally, price cap regulation restricts regulated firms from increasing the annual prices on its services by the difference in the percent change in inflation minus a productivity offset (also expressed in percent form). This offset, sometimes referred to as an *X-factor*, is roughly equal to the historical percent change in TFP and is often increased by a stretch factor of one-half percent or more.[1]

Assume a company has experienced a 1% historical annual average gain in productivity. In this example, annual prices could be increased by the percent change in inflation minus an offset of 1.5% -- specifically, the annual historical productivity of 1% plus a stretch factor of 0.5%. This means that a 2.7% increase in annual inflation (in the latest year) would allow the weighted market basket of service prices to increase by no more than 0.8% from the prior year. As a benchmark, multifactor productivity for the private business sector increased at an average annual rate of nearly 1% from 1987 to 2015.[2]

The benefit of price caps is that it reduces the cost of regulatory surveillance, requires the regulated firm to attain historically rates of operational efficiency, and encourages the firm to outperform the established productivity offset, which would allow the firm to increase its earnings. This last component represents the very incentive referred to in Objective #1, where price cap regulation encourages the regulated firm to reduce its costs and increase operational efficiency. When the firm outperforms the productivity offset, the additional earnings it produces can then be redeployed or reinvested, paid to shareholders or employees, or used to keep rates lower than permitted under the regulatory cap. If a price cap firm does not exceed its productivity offset, it does not produce additional earnings, and it cannot justify investing in ventures outside of its regulated market basket of services.

Because the USPS' rate changes are capped by the percent change in the Consumer Price Index, the price cap formula allows annual increases in rates to keep pace with the general rate of national inflation. This formula does not include a productivity factor, nor does it include a stretch factor. In effect, the formula does not require the USPS to improve its level of operational efficiency, despite the USPS' own claims that its historical TFP increased on an annual average rate of 1.1% from 2000 to 2010.[3] This undemanding productivity target of 0% provides the USPS an easily achievable means to increase its earnings.

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[1] Mark Jamison, "Regulation: Price Cap and Revenue Cap," Encyclopedia of Energy and Engineering and Technology, Vol. 3, Barney Capehart, ed., pp. 1245-51, New York: CRC Press, Taylor and Francis, 2007, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=959684. Jamison correctly points out that the FCC increased the x-factor on interstate services by an explicit stretch factor 0.5%, while Canadian regulators imposed a 1% stretch factor on local exchange carrier services (at p. 7).

[2] See the Bureau of Labor Statistics, Net Multifactor Productivity and Costs, 1987 to 2015, published online on May 5, 2016, at https://www.bls.gov/mfp/special_requests/prod3.mfptable.xlsx. This figure excludes government enterprises.

[3] See https://about.usps.com/who-we-are/financials/annual-reports/fy2010/ar2010_finance_042.htm. In fact, the USPS' TFP has declined only once since 2009, according to testimony of Lori Rectanus, "U.S Postal Service: Key

To be clear, the current price cap formula fully incents the USPS to reduce its costs and increase productivity, and that objective should be easily achievable though managing its volumes of business versus its productive inputs – namely, labor, capital, material, transportation, rents and services. However, the USPS has failed to take advantage of this basic incentive by failing to reduce its costs and increase its operational efficiency, and thus it has failed to build its earnings and achieve financial stability. Instead, the USPS posted a $5 billion loss last year, and it has now accumulated roughly $62.4 billion in losses since the enactment of Postal Accountability and Enhancement Act in 2006.[4]

The USPS was provided an easy pathway to increase its earnings, but it has clearly failed to meet Objective #5 and, in doing so, has demonstrated dysfunctional management of its business volumes versus its productive inputs.

Price cap mechanisms work, but they assume that regulated firms are driven to be financially solvent and want to increase earnings. Instead of being profit motivated, the USPS appears to be over-reliant on some future government backstop to cover its losses. While the objective of the price cap is to incent cost reduction and beat inflation, it appears that the USPS is more interested in becoming a debtor, rather than a cost cutter.

What should be done? If the USPS is experiencing lackluster productivity growth, that financial performance is inexcusable and should not be rewarded. The Commission should keep the undemanding price cap mechanism as is, but require the USPS to produce positive earnings. In order to do this, the USPS should develop an aggressive cost reduction plan, including automated cuts in management, should it fail to produce positive earnings. Allowing the USPS' financial condition to be considered in labor arbitration would be beneficial. In addition, the USPS should immediately redeploy its resources away from its unregulated ventures to bolster its regulated services, including discontinuing services that are already provided in the private sector.

Failure to Meet Quality of Service and Just and reasonable Rates Objectives

In analyzing the U.S. Postal Service's operational concerns through numerous cases considered by the Commission, ACI continues to express that systemic changes will be needed to ensure that the Postal Service can remain a viable institution. Despite advancements in technology in sending information, the reality is that letter mail delivery remains a core service and an instrument of commerce for millions of individuals across the country.

Considerations for Restoring Fiscal Sustainability," United States Government Accountability Office, GAO-17-404T, released February 7, 2017, p. 5, at https://oversight.house.gov/wp-content/uploads/2017/02/Rectanus.pdf.

[4] Ibid, p. 3.

As such, the Postal Service was founded with the universal service obligation to provide efficient letter mail at a reasonable rate – a responsibility that has inappropriately become neglected. Specifically, the intersection of the Postal Service's failure lies in the inability to achieve two other key objectives:

- Objective 3 – To maintain high quality service standards established under section 3691; and
- Objective 8 – To establish and maintain a just and reasonable schedule for rates and classifications.

About service standards, the Postal Service has either maintained or relaxed its targeted goals for the percentage of on-time delivery for a variety of specified mail classes. Despite its overall reduced objectives to transport mail in a timely manner, the USPS has further allowed its actual reported metrics for performance to deteriorate by an even greater magnitude.

Specifically, in 2015 the Postal Service reported its failure to meet revised performance targets for all segments (overnight, 2-Day, and 3-5-Day) of First-Class Single-piece letters, Presorted letters, Outbound Single Piece, and Inbound Letter Post. Similarly, Standard mail classes, including Letters, and Carrier Routes have also failed to meet targets each of the last five years.

Based on the revenue that the USPS is generating on these products, it is apparent the agency has sufficient resources available to make significant improvements in on-time deliveries. Traditional letter mail has contributed significant financial gains as all First-Class letters have covered their costs by 248 percent, bringing in over $15 billion in net profits in 2016 alone.

Instead of choosing to dedicate its extensive financial gains from First-Class letters toward the immediate needs of its core services, improving service quality, or starting to pay off its liabilities, the Postal Service prioritizes bringing to market more and more non-essential services. Such new ventures have consistently lacked adequate financial analysis to answer critical questions about their feasibility given that the services face fierce competition among numerous well-established providers. Effectively, the USPS is taking its gains from monopoly services facing poor service quality performance, and using these gains to launch and operate low margin and unprofitable competitive services. This represents a misallocation of resources.

Additionally, with such great profitability of letter mail in mind, the Postal Service's continued pursuit of rate hikes has escalated beyond what can be considered just and reasonable. American Consumer Institute has frequently expounded upon the most recent price increases that have only further gouged mail customers.

Exceeding the price cap objective and producing additional earnings should be required before allowing any expenditures or investment to go to unregulated ventures. Because the USPS has failed to achieve its objectives, the alternative should not be for higher prices on its services, but require the company to discontinue its competitive services and decrease its inputs of production. Productivity means doing more with less. Simply allowing the flexibility to increase consumer prices for its core services and allow deteriorating service quality is not the answer.

Summary

In conclusion, the Commission would be well-served to thoroughly analyze the mountain of evidence elucidating the harm caused to mail customers directly through the misguided actions by the Postal Service. The USPS regulated prices should continue to be subject to a price cap, and be required to develop an aggressive cost cutting plan. In addition, the USPS should be required to discontinue its competitive services, and focus these resources and its attention toward improving quality of service. The USPS should not be allowed to accumulate losses.

Going forward, the USPS should produce earnings and use those earnings as a financial cushion for the future. Failure by the USPS to meet its objectives should not be the financial responsibility of the taxpayer; it should be solely the financial responsibility of the USPS. Until the USPS take full responsibility and accountability for its financial performance, it will not make the systematic changes necessary to achieve its objectives, and failure to meet these objectives will impact those who use and rely on the mail system the most.

Respectfully yours,

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